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### Legal and Practical Issues Involved with Maquiladora Financing

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# Legal And Practical Issues Involved With *Maquiladora* Financing\*

*Sandra L. Shippey\*\* and Patrick W. Martin\*\*\**

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The purpose of this article is to generally describe the legal and practical issues of concern to a lender or lessor, considering whether to become involved in the *Maquiladora* financing business.

## I. What is a "*Maquiladora*?"

A *Maquiladora* is a creation of Mexican law.<sup>1</sup> It is a business whose operations are approved by the Ministry of Commerce and Industrial Development (SECOFI). The *Maquiladora* industry was created through the Decree for the Development and Operation of the *Maquiladora* Export Industry ("*Maquiladora* Decree").<sup>2</sup> It is generally a Mexican company ("Mexican Subsidiary") operating under a program of special customs treatment. It is often a subsidiary of a United States corporation ("U.S. Parent") operating a manufacturing or assembly plant in Mexico. The U.S. Parent provides the management, equipment, and inventory to the *Maquiladora*, and the *Maquiladora* provides the plant infrastructure and the Mexican work force. It is also possible for the U.S. Parent to operate a *Maquiladora* through a company ("Mexican *Maquiladora*") that hires out its services to assist with manufacturing operations. For convenience of reference, when the term *Maquiladora* is used in this article, it will refer to a *Maquiladora* that is either a Mexican Subsidiary, or a Mexican *Maquiladora*, unless otherwise stated. The following illustrates the general structure of *Maquiladora*

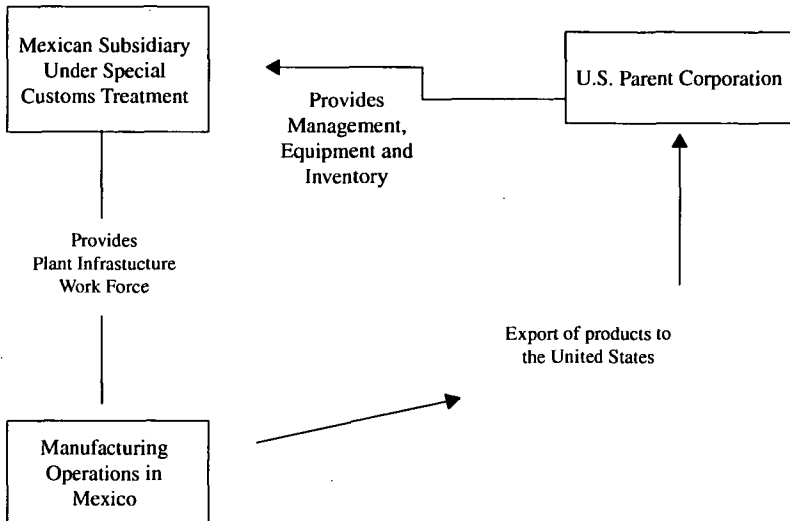
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1. See "Ley Aduanera" [Customs Law], D.O., Dec. 15, 1995 (Trade and imports and exports are regulated in Mexico by the Customs Law, a Federal Statute, and its Regulations).

2. See "Decreto para el Fomento y Operación de la Industria Maquiladora de Exportación" [Decree for the Development and Operation of the *Maquiladora* Export Industry], D.O., June 1, 1998.

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operations:



Generally, the *Maquiladora* program provides special customs treatment permitting the *Maquiladora* to temporarily import most everything that a *Maquiladora* will need for production, including machinery, equipment, replacement parts, and raw materials ("Eligible Property"). There is no duty on the import of the Eligible Property to Mexico, because the import is on a temporary basis.<sup>3</sup> With some exceptions, the *Maquiladora* is required to return all of the Eligible Property to the United States. Also, in the case of equipment shipped to Mexico and later returned to the United States, there is generally no duty to be paid at the time of such re-exportation to the United States in most situations.<sup>4</sup>

Prior to the passage of the North American Free Trade Agreement ("NAFTA"), *Maquiladoras* were required to export all of their production. This strict requirement has been loosened somewhat since the passage of NAFTA.<sup>5</sup> In 1994, a *Maquiladora* was able to sell 55 percent of the total value of its annual exports for the previous year in Mexico. This limit gradually increased through the year 2000, and currently all such limitations have been removed.<sup>6</sup>

Until 1988, Mexican customs generally required the posting of a bond or other collateral to guarantee that the temporarily imported items would be exported out of Mexico. Since July 1, 1988, the *Maquiladora* Decree exempted importations of raw materials from the requirement of posting a bond or collateral in favor of a "guaranty letter." In any event, the additional cost for the bond is generally not significant.

3. See Ley Aduanera §§104, 1.

4. *Id.* §106.

5. See North American Free Trade Agreement [hereinafter NAFTA], June 1, 1994, U.S.-Can.-Mex., 32 I.L.M. 605, Part Two, Chapter Three.

6. *Id.* arts. 303-305.

Given the production of high technology products and consumer goods for international markets, the *Maquiladora* industry has become one of the most important export sectors in Mexico. Its technological strength, among other advantages, combined with a competitive labor force and a strategic location, have helped the industry establish Mexico as the 8th largest exporter in the world.<sup>7</sup> In the year 1998, when the *Maquiladora* Decree was issued, nearly 400 *Maquiladora* operations were approved by SECOFI, and the number of manufacturing plants in Mexico increased to 4,235 (compared to 2,405 plants existing in 1993).<sup>8</sup>

## II. What is a “*Commodatum*?”

A “*Commodatum*” is an agreement between the U.S. Parent and the *Maquiladora*, pursuant to which the U.S. Parent agrees to deliver the Eligible Property to the *Maquiladora*. The *Maquiladora* is given the status of a bailee of the Eligible Property, acting on behalf of the U.S. Parent. The *Commodatum* must: (i) cover the scope of the operation, (ii) provide that the title to the Eligible Property must remain with the U.S. Parent at all times, (iii) acknowledge the consignment of the Eligible Property to the *Maquiladora*, and (iv) contain a statement that the Eligible Property will be returned to the United States.

The *Commodatum* must be written in both English and Spanish, and must be recorded with the appropriate Public Registry of Property and Commerce (“Public Registry of Property”) in Mexico to evidence the ownership of the assets in the U.S. Parent. Generally, the appropriate Public Registry of Property will be in the city in which the Eligible Property will be located. The *Commodatum* must be renewed every two years. It is important to remember that the *Commodatum* may be terminated by the U.S. Parent at any time. Therefore, as discussed in more detail below, it is important that the lender or lessor be a party to the *Commodatum* to avoid a situation in which the *Commodatum* is modified or terminated without the lender or lessor’s knowledge or consent.

## III. What is “*Maquiladora* Financing?”

The term “*Maquiladora* Financing” will be used in this discussion to describe a situation in which: (i) a loan is made by a United States lender (“U.S. Lender”) to a U.S. Parent, or (ii) a lease is entered into between a U.S. Lender and a U.S. Parent. In both situations, the collateral or leased equipment, as applicable, will consist of the Eligible Property that is being imported into Mexico from the United States under the *Maquiladora* program. There is no technical term known as “*Maquiladora* Financing,” rather this term is used for purposes of this discussion.

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7. Data provided by SECOFI in 1999 at <http://www.siem.gob.mx/portalsiem/> [last visited Aug. 24, 2002].

8. *Id.*

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## IV. U.S. Documentation

### A. LOAN DOCUMENTATION

Generally, the first layer of loan documentation for a *Maquiladora* Financing transaction is the same as for a wholly domestic United States transaction. The borrower is the U.S. Parent. The documentation will include a loan agreement, a promissory note, a guaranty, and any related collateral documentation, such as one or more security agreements as appropriate based upon the credit approval. A Uniform Commercial Code financing statement should be filed against the borrower at the secretary of state's office, of the state whose law governs the transaction. Usually this is the state where the borrower is "located," so that the lender's security interest in the collateral will be perfected as required by the Uniform Commercial Code.<sup>9</sup> All of these loan documents will be governed by the Uniform Commercial Code, as enacted in the applicable state whose law will govern the transaction, and other relevant state laws generally governing commercial loan transactions.

These loan documents will be enforceable in the United States against the U.S. Parent. If and when the collateral is returned to the United States, the lender should have the same rights against the collateral as it would in any other secured transaction. This discussion will not review the United States legal issues involved in commercial lending transactions in detail, because it is assumed that a general understanding exists as to the legal issues arising under U.S. law in commercial lending transactions. It is recommended, however, that the promissory note and security agreement refer specifically to the fact that the promissory note is also secured by a pledge contract governed by Mexican law. In addition to the documentation described above, because the equipment will be located in Mexico, additional documentation should be prepared and filed in Mexico, in order to perfect the lender's interest in the collateral under Mexican law.

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9. Although a broad discussion of Revised Article 9 of the Uniform Commercial Code ("Revised Article 9") is beyond the scope of this discussion, it should be noted generally that §9-301 of Revised Article 9, provides that the law governing the perfection of security interests will be the law of the debtor's location. Most borrowers, including the U.S. Parent in a *Maquiladora* Financing transaction, will likely be registered organizations such as a corporation, a limited partnership or a limited liability company. §9-307(e) of Revised Article 9 provides that a registered organization that is organized under the laws of a State, is located in that State. For example, a Delaware corporation will always have Delaware as its state of organization, because to create a Delaware corporation, articles of incorporation must be filed in Delaware. Of course, this would apply to limited partnerships and limited liability companies, as well and their state of organization, would be the state in which they filed their certificate of limited partnership or articles of organization, respectively. Section 9-501(a)(2) of Revised Article 9 provides that the proper place to file a financing statement (other than against collateral consisting of as-extracted collateral, timber or fixtures) is the Secretary of State's office in the state whose law governs the transaction. Of course, the place for filing financing statements governing as-extracted collateral, timber and fixtures has not been changed under Revised Article 9, and such filing must be made with the office designated for the filing or recording of mortgages on the related real property. However, since *Maquiladora* Financing transactions will involve collateral used in Mexico, there will generally never be a need for a fixture filing in the United States. For more information, see <http://www.law.cornell.edu/ucc/ucc.table.html> [last visited Aug. 22, 2002].
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## B. LEASE DOCUMENTATION

Similar to the situation regarding loan documentation, the documentation required for lease documentation is substantially the same as for a United States leasing transaction. It will generally include a master lease, an equipment schedule, a purchase order assignment or direct purchase order, a certificate of acceptance, stipulated loss and termination value tables, and any guaranty or additional collateral documents as may be required by the credit approval. As noted above with respect to loan documentation, this discussion will not review the United States legal issues governing lease transactions in detail, because it is assumed that a general understanding exists as to the United States legal issues involved in commercial leasing transactions. In addition to the documentation described above, because the equipment is located in Mexico, additional documentation must be prepared and filed in Mexico in order to perfect the lessor's interest in the collateral under Mexican law. See the discussion below under the heading "Specific Mexican Legal Issues Regarding Maquiladora Lease Transactions."

## C. SPECIFIC CONTRACTUAL PROVISIONS RECOMMENDED TO BE INCLUDED IN THE UNITED STATES DOCUMENTATION

It is recommended that the following special provisions be included in the United States documentation, including the security agreement and/or the lease. Some of the following suggested provisions may already be included in a lender or lessor's standard documentation. It would be convenient to prepare: (i) a separate addendum to a standard security agreement, and (ii) a separate addendum to a standard lease, each of which could be used with all standard Maquiladora financing transactions.

### 1. *Acknowledgment of Assignment of Collateral or Leased Property from U.S. Parent to the Mexican Subsidiary*

Most loan documentation contains prohibitions against a borrower or lessee assigning its rights to the collateral or leased property to a third party. This should be modified to specifically acknowledge the planned assignment or sublease from the U.S. Parent to the Maquiladora.

### 2. *Taxes; Fees; Shipping Expenses*

The borrower or lessee should be required to pay any extra taxes, duties, fees or other expenses incurred to ship the collateral or leased property to Mexico, whether such charges are levied by the United States or the Mexican authorities.

### 3. *U.S. Export License*

If required by the type of collateral or leased equipment, the borrower or lessee should be required to obtain an export license for the collateral or leased equipment, and should represent and warrant to the lender that the export of the collateral or leased equipment, will be done in full compliance with both the laws of the United States and Mexico. The lender must provide a copy of the export license. It should be noted that United States law contains restrictions for the export of some types of property, such as some high technology equipment to some countries, and restricts exports generally to



certain countries. The lender's counsel in connection with any Maquiladora financing transaction should also review these issues.

#### 4. Mexican Import Filing

The borrower or lessee is required to file an "Importer of Record" document with Mexican customs, which details the value of the collateral or leased property, and the expected use thereof.<sup>10</sup> A copy of this document should be delivered to the lender showing a detailed description, and identification of the property imported into Mexico in order to clear customs, and avoid export duties when the property is re-exported back to the United States.

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10. Section 36 of Ley Aduanera, provides the documents that should be filed along with this document, such as invoices, transportation, warranties and other documents to account for the origin and means of transport of the imported property:

Section 36. Any merchandise importer or exporter shall file before customs, through its agent or customs representative, a request in the official form approved by the Ministry. In the event the merchandise is subject to nontariff regulations and restrictions, and its compliance is proved through electronic means of communication, the request shall include the electronic signature that proves compliance with such regulations or restrictions. Such request shall be filed along with:

1. For Imports:

- a) Commercial invoice with the requirements provided by Ministry rules, if the merchandise value at customs is determined according to the value of the transaction, and the value of such merchandise exceeds the amount set in such rules.
- b) Shipping documents, whether by transportation by air or by waters, both shall be certified by the shipping corporation.
- c) Documents to prove compliance with nontariffs import regulations and restrictions that have been issued under the Foreign Exchange Law, provided that the same have been published in the Official Journal of the Federation, and identify the corresponding tariff fraction and denomination assigned under the General Import Tax Law.
- d) The document that certifies the origin of the merchandise for purposes of tariff preference treatment, quotas, country of origin classification, and other measures that may be established, according to applicable legal provisions.
- e) The document representing the guarantee established by Ministry rules, when its value is lower than the estimated price determined by such Ministry.
- f) The certificate of weight or volume issued by the certifying office approved by Ministry rules, in the case of merchandise determined by weight in zones of maritime traffic, in the cases established in the Regulations.

In the event of merchandise that may be identified individually, the serial number, parts, trademark, model, or technical or commercial specifications necessary to identify the merchandise, and distinguish them from other similar merchandise, in the event such information is available. This information may be described on the request, the invoice, the shipping document, or on a separate list describing the request number, signed by the importer, customs agent or representative. *Id.*

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### 5. *Continuing Obligation to Maintain Perfection*

In general, the security agreement or lease requires the borrower or lessee to make any required filings and registrations in both the United States and Mexico, in order to protect the lender or lessor's interest in the collateral or leased property.

### 6. *Use of Collateral or Leased Property*

The U.S. Parent and the Maquiladora should be required to use the collateral or the leased property, in full compliance with the Commodatum, Mexican law, and any rules and regulations applicable to the use of the collateral or leased property. In addition, the borrower should indemnify the lender against violations of the Commodatum and Mexican law.

### 7. *Mexican Insurance*

The U.S. Parent should be required to provide the lender or lessor with evidence of insurance that is valid in Mexico, covering the collateral or leased property while it is in Mexico. Most insurance issued in the United States is not valid in Mexico, absent special riders to the policies.

### 8. *Risks of Collateral Located in Mexico*

The U.S. Parent should assume all risks relating to the relocation of the collateral or leased property to Mexico including, but not limited to, the effects of all economic and political changes, any change or abolishment of the Maquiladora program, devaluation, any change in tax relief afforded to the Maquiladora program, or policy chances of the United States and/or Mexican governments concerning importing and exporting.

### 9. *Right of Inspection; Reporting Requirements*

The lender or lessor should be granted the ability to inspect the books and premises of the Maquiladora at any time, and should exercise that right from time to time as required by the terms of the credit approval. Alternatively, or in addition to a right of inspection, a lender might consider requiring regular reports of the location and/or relocation of the collateral or leased property. Because there is no floating lien per se under Mexican law, any reporting requirement should also include a requirement to give a specific identification of all collateral or leased property, from time to time. This will help avoid a situation in which a substitution of collateral is made by the Maquiladora, and the lender/lessor loses its interest in the substituted collateral because a new filing is not made. Also, because labor liens take priority over a secured creditor's lien as discussed elsewhere herein, a lender should consider requiring the reporting of all labor claims made against the Maquiladora in order to avoid a situation, where labor liens take precedence over the lender's position in the collateral. This would also be a good idea for lessors as part of an ongoing review of the financial condition of the Maquiladora.

### 10. *Return of Collateral*

Upon default under the loan or lease documentation, the U.S. Parent and the Maquiladora should promise to return the collateral to the United States upon the lender

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or lessor's demand. Further, this clause should specifically state that the property must be returned in a condition that would allow it to be legally used in the United States without any modification, repair or improvement. Specifically, the property should be required to be returned in full compliance with safety, health and environmental laws, and regulations applicable in the United States. The United States laws are generally more stringent in these areas than the corresponding Mexican laws.

#### 11. *Waiver of Defense*

There should be a general waiver of defenses that might arise because of the location of the collateral in Mexico.

#### 12. *Requirement that the Borrower or Lessee Provide Copies of Some or All Relevant Maquiladora Documentation*

Depending upon the creditworthiness of the U.S. Parent, the lender or lessor may want to require the U.S. Parent to provide to the lender or lessor, for review, copies of all of the permit and license applications and approval documentation required for the U.S. Parent to participate in the Maquiladora program including the following:

##### a. *Maquiladora Agreements*

Each agreement that the U.S. Parent has entered into with its Maquiladora which sets forth the relationship and obligations between the two companies, or under which the assets to be used by the subsidiary are owned by the U.S. Parent and "bailed" to the Maquiladora (often called the "Manufacturing Agreement" and/or the "Commodatum" or Bailment Agreement).

##### b. *Evidence of Payment of Import Duty*

Documentary evidence that the U.S. Parent has paid any applicable import duty or posted a bond in lieu of such duty payment.

##### c. *Documents Submitted to the Mexican Government*

Any document that the Maquiladora has submitted to the Mexican government that sets forth all the pertinent data relating to the proposed operation of the Maquiladora, and evidence that such document has received all necessary approvals by the Mexican government, should be included in the documentation. As part of the due diligence review of the Maquiladora, the lender or lessor should confirm the corporate good standing of the Maquiladora. The relevant Maquiladora documentation to review includes: (i) a permit from the Secretariat of Foreign Relations which is necessary to incorporate any company in Mexico; (ii) notarized articles of incorporation which should be on file with the applicable Public Registry of Property; (iii) the corporate bylaws of the Maquiladora which should be on file with the applicable Public Registry of Property; (iv) approval from the Secretariat of Commerce and Industrial Development—a Mexican federal agency which approves the Maquiladora programs and oversees compliance—for participation of the Maquiladora in the Maquiladora program, which is generally renewed every two years; (v) registration with the Secretariat of Finance and Public

Credit as an exporter/importer; (vi) registration with the Secretariat of Social Development, the Mexican federal agency which oversees environmental issues, and requires certain filings to assure that any operating plants meet Mexican environmental standards; (vii) registration of the Maquiladora with the Public Registry of Property in the city where the Maquiladora has its corporate domicile; (viii) any registrations and licenses from the appropriate federal, state, and local taxing and operating authorities; and (ix) any permits required from the local authorities concerning operation of the Maquiladora or any environmental issues.

d. Certificate of Registration with United States Customs

Documentary evidence that the U.S. Parent has received a certificate of registration with United States Customs concerning the exports to Mexico.

13. *Choice of Law, Jurisdiction, and Venue*

Generally, lenders and lessors will require that the law of the United States, and a particular state will govern the transaction, and that jurisdiction and venue are in a convenient forum in the United States. Since the U.S. Parent is not foreign, there will be no need for consent to service of process in the United States. However, such a provision may be used for the Maquiladora itself, and is recommended.

14. *Legal Expenses; Opinion of Counsel*

Often, lenders and lessors will require the U.S. Parent to pay the cost of the legal expenses required to coordinate the appropriate filings in Mexico. These legal expenses are likely to range between \$3,500 and \$7,500 if no unusual issues arise in connection with the transaction. They could be higher at the commencement of a Maquiladora financing program, as the credit and legal personnel of the lender or lessor become familiar with the procedures necessary to complete these transactions. In addition, for certain large transactions, a lender or lessor should consider whether to require the Maquiladora to provide an opinion of counsel from an acceptable Mexican law firm, and in a form acceptable to the lender or the lessor.

## V. Mexican Legal Issues Regarding Maquiladora Loan Transactions

### A. MEXICAN LAW OF PLEDGES

In addition to the United States loan documentation referred to above, certain Mexican documentation will be required in order to protect the lender's interest in the collateral, because the collateral will be physically located in Mexico. Mexican law will govern this documentation. To understand how this works, it is important to have a basic understanding of the Mexican law of pledges. Mexican commercial law is found in the Law of Negotiable Instruments and Credit Transactions ("LNICT"), the Commerce Code ("Commerce Code") and the Civil Code of Mexico ("Civil Code").

Traditionally, in Mexico, a security interest in personal property is obtained through a "pledge" of such personal property. Generally, a pledge may be obtained for any

movables, which are alienable, i.e., personal property which may be sold to satisfy the obligations secured by the pledge.<sup>11</sup>

Under Mexican law, a creditor must obtain actual possession of personal property to "perfect" a pledge of such property unless an exception to the possession requirement is available.<sup>12</sup> There is an exception to the actual possession requirement in situations where a third party depository is used to hold the collateral on behalf of the lender, and the pledge contract is recorded with the Public Registry of Property for the appropriate jurisdiction.<sup>13</sup> This is the exception to the possession requirement that is generally used to protect lenders in *Maquiladora* financing transactions.

### 1. Nonpossession Guaranty

As of May 24, 2000, Mexico's LNICIT, the Commerce Code and the Law of Credit Institutions, were amended to modernize Mexico's secured transactions. The author's law firm consulted with a Mexican Congressman that was instrumental in bringing about these changes. As a result, it is now possible for a debtor to remain in possession of secured movable personal property. The property does not have to be deposited with the creditor or a third depository ("Nonpossession Guaranty"). The purpose of these provisions is to help guarantee compliance of the debtor's obligation, while allowing the debtor to have possession of the secured property and use it in his operations or business. This type of pledge is known as a pledge without dispossession, or *Prenda sin transmisión de posesión*. Mexico had no effective secured financing laws (comparable to Article 9 of the Uniform Commercial Code) prior to these amendments. A Nonpossession Guaranty may only be used regarding movable property.<sup>14</sup> These recent amendments provide that any obligation, regardless of the activity or business performed by the debtor, may be secured through a nonpossession guaranty.<sup>15</sup>

### 2. Guaranty Trust

These recent amendments also include new provisions regarding a Guaranty Trust, or *Fideicomiso en Garantía*. Under Mexican law, the Trustee must be a Mexican financial institution, because only banks and institutional stockbrokers (as opposed to individual stockbrokers) may act as Trustees.<sup>16</sup> The only limit to the purpose or objective of a Mexican trust is that it shall be a "legal determined purpose."<sup>17</sup>

Under the Guaranty of Trust provisions, the settlor (debtor) transfers to the trustee (a bank, an insurance institution, a bond institution, or a grantor public warehouse)<sup>18</sup>

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11. General Law of Negotiable Instruments & Credit Transactions [hereinafter L.T.O.C.], arts. 334, 335, D.O., Aug. 27, 1932.

12. "Codigo Civil para el Distrito Federal" [Mexican Federal Civil Code] [hereinafter C.C.D.F.], art. 2858, D.O., Dec. 24, 1996, see <http://www.solon.org/Statutes/Mexico/Spanish/cc-intro.html> [last visited on Aug. 22, 2002].

13. *Id.* art. 2859.

14. L.T.O.C., art. 346.

15. *Id.* art. 352.

16. LCI, art. 46, XV; Stock Market Act, art. 22, IV (d). Institutional stockbrokers may only be a party to a trust if it is directly related to its financial services and operations. *Id.*

17. L.T.O.C., art. 346.

18. *Id.* art. 399.

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his title over certain personal property, to guarantee the performance of an obligation and a right of preference of payment in favor of the beneficiary (lender or creditor).<sup>19</sup> Any type of rights, including movable and real property, may be subject to a Guaranty of Trust.<sup>20</sup> Similar to the Nonpossession Guaranty, unless otherwise agreed to between the parties, the debtor shall continue in possession of the movable property, and may use and even sell this property.<sup>21</sup>

In transactions where the secured property is real estate, the Guaranty of Trust must be granted in a public deed before a Mexican Notary Public,<sup>22</sup> and recorded before the Public Register where the real estate is located.<sup>23</sup>

The most striking difference between a Guaranty of Trust and traditional forms of secured transactions in Mexico, is that with a Guaranty of Trust it is possible to execute and foreclose against the secured property extra judicially. In general terms, the parties must first obtain an appraisal of the secured property,<sup>24</sup> then the property is delivered to the trustee or the beneficiary (creditor or lender) before a Public Notary, who must draft the public record as well as inventory the property.<sup>25</sup> The trustee or beneficiary may then sell the property. Instead of requiring judicial authority for the execution of the secured property, the "authority" in this extra-judicial procedure is the Public Notary, who has special powers such as delivering to the settler a notice of delivery of the property.<sup>26</sup>

However, these amendments also introduce a new special summary procedure before Commercial Law courts. Therefore, the involvement of the courts continues to be a characteristic of secured transactions in Mexico. In the case of controversy regarding demand of payment, the amount claimed by the beneficiary or creditor, or delivery of secured property, the parties will not be able to execute the secured property extra-judicially.<sup>27</sup>

## B. THE PLEDGE CONTRACT

### 1. *Formal Requirements*

#### a. *Written Pledge Contract*

To formally establish the lender's constructive possession over the pledged assets, the U.S. Parent, as pledgor, the lender, as pledgee, and the *Maquiladora*, as a "third party pledge depository" must enter into a written pledge contract.<sup>28</sup> The *Maquiladora* acts as a "third party pledge depository," or the "custodian" to hold all of the pledged assets for the benefit of the lender, thereby giving the lender "constructive possession" of the collateral.

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19. L.T.O.C., art. 395.

20. *Id.* art. 401.

21. *Id.* art. 402.

22. *Id.* art. 407.

23. L.T.O.C. art. 410.

24. *Id.* art. 1414 *bis*.

25. *Id.* art. 1414 *bis* 3.

26. *Id.* art. 1414 *bis* 1.

27. *Id.* art. 1414 *bis*.

28. Under article 28680 of the Civil Code, the pledge contract must be in writing. *Id.*

b. Collateral Description

The pledge contract must contain a complete and accurate description of the pledged assets with particularity.<sup>29</sup> Under Mexican law, general descriptions of collateral, such as "all equipment" are only acceptable, if all equipment used for production or in debtor's main activity is pledged.<sup>30</sup> The equipment description must also be in Spanish.

c. Required Value of Collateral

Article 340 of the LNICT requires that the value of the pledged assets must exceed the balance of the debts they secure by at least 20 percent at all times. This requirement can be waived by a lender advancing a loan in excess of the required collateral coverage, or by the lender providing a written waiver. If no waiver is given, the lender has the right to petition a Mexican court to immediately sell the pledged assets, if the required collateral coverage is not in place.

d. Filing with the Public Registry of Property<sup>31</sup>

The pledge contract must be filed with the Public Registry of Property in the city where the collateral will be located, in order to put the world on notice of the pledge, and to give the pledgee priority over any other dispositions of the personal property.<sup>32</sup> However, the creation, amendment, termination, assignment and judicial resolutions regarding a nonpossession guaranty must be recorded in the Public Registry of Commerce.<sup>33</sup> In order to be filed with the Public Registry of Property, the pledge contract must be written completely in Spanish. To lower costs, it is recommended that a standard form of pledge contract be prepared and translated into Spanish rather than writing individual pledge contracts for each transaction which would then have to be translated individually. The cost of the filing with the Public Registry of Property depends upon the value of the collateral, and the jurisdiction in which the filing is to be made, but generally the filing fee is approximately 0.9% of the value of the collateral.

e. Signatures, Notarization, and Legalization of Documents;  
Authorization to Sign Documents on Behalf of the *Maquiladora*

(i) Execution of Documents in the United States

The pledge contract will be signed in the United States by the lender, the U.S. Parent, and sometimes by the *Maquiladora*, if the *Maquiladora* has officers or other employees who are authorized to sign on behalf of the *Maquiladora*, physically located in the United

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29. L.T.O.C. art. 354.

30. *Id.* art. 354.

31. There are two main Registers in Mexico. First, the Public Register of Property, which records property that belongs to private individuals, and contains information such as surface area, location and boundaries, name of the owner and operation by which it was acquired, and any liens or encumbrances that exist on the property. Second, the Public Register of Commerce records corporations and partnerships, and related entity information such as names, address, main business activities, and representatives of recorded.

32. C.C.D.F., art. 2857.

33. L.T.O.C., art. 376.

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States. For all parties signing the pledge agreement in the United States. The signatures should be performed in front of a United States Notary Public. Then the notarized documents should be presented to the Mexican Consulate, in the same region where the United States Notary Public is located, so that the signature of the Notary Public can be *legalized* under Mexican law.

(ii) Execution of Documents in Mexico

If the signatures of the *Maquiladora* are to be obtained in Mexico, the Mexican parties must perform their signatures in front of a *Corredor Público*, an expert in commercial transactions specially authorized by the State to formalize certain operations, similar to a Mexican Notary Public.<sup>34</sup> In order to sign documents of the *Corredor Público*, the signing party will be obligated to prove to the *Corredor Público*, his authority to sign on behalf of the *Maquiladora*. This is done by providing to the *Corredor Público* a copy of the *Maquiladora*'s bylaws, or a power of attorney, which is discussed in more detail in the following paragraph. In Mexico, a *Corredor Público* has a more important role than a Notary Public in the United States. His signature provides formal evidence of the execution of the document, but he is also charged with reviewing the documentation to determine compliance with applicable Mexican laws. A *Corredor Público* must be an attorney who is specifically licensed by the Mexican government to act in such capacity.<sup>35</sup>

(iii) Authorization to Sign Documents on Behalf of the *Maquiladora*

No matter where the *Maquiladora* signatures are performed, it is important to review, as part of the due diligence in connection with any *Maquiladora* financing: (i) a copy of the bylaws of the *Maquiladora* indicating which parties are authorized to sign documents on behalf of the *Maquiladora*, and/or (ii) a copy of the Power of Attorney by which the *Maquiladora* has authorized someone in the United States to sign documents on behalf of the *Maquiladora*.<sup>36</sup> Sometimes the Power of Attorney is contained in the body of the bylaws themselves.<sup>37</sup> A lender should determine, especially with respect to larger transactions, whether to also require a legal opinion from Mexican counsel that: (i) all corporate action authorizing the *Maquiladora* to enter into the applicable documentation, and to act as a third party depository on behalf of the U.S. Parent and the lender, have been taken, and (ii) the individuals signing the Pledge Agreement and the *Commodatum* on behalf of the *Maquiladora* have the power to bind the *Maquiladora*. It should be noted that Mexican attorneys generally do not have malpractice coverage, but the opinion may be worthwhile for the due diligence that goes behind it, and if that same attorney is requested to enforce the documentation upon a default, the attorney may have a greater incentive to perform on behalf of the lender.

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34. "Ley Federal de Correduría Pública" [Public Brokerage Federal Law] [hereinafter L.F.C.P.], D.O., art. 6.

35. L.F.C.P., art. 8.

36. "Ley General Comerciales De Companias" [General Commercial Corporations Law] [hereinafter L.G.S.M.] art. 10, D.O., June 30, 1997.

37. *Id.* art. 10.

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(iv) Use of Mexican Counsel

Once the signatures obtained in the United States have been notarized and the documents have been *legalized*, the documents will be ready to be sent to Mexican counsel for the appropriate filings. As discussed above, legal fees for Mexican counsel will likely be between \$3,500 and \$7,500, if no unusual issues arise. As noted above, they could be somewhat higher in the early transactions documenting in a new *Maquiladora* financing program. These fees will decrease as the credit and legal personnel become familiar with the documents and procedures required for these transactions.

2. *Perfection of the Lender's Interest in the Collateral*

a. General

By using the *Maquiladora* as a third party "pledge depository," the lender's interest is perfected without actual possession of the collateral, so long as the Spanish version of the Pledge Contract and the *Commodatum* are recorded with the Public Registry of Property in the city where the collateral will be located in Mexico. Additionally, the nonpossession guaranty allows the debtor to remain in possession of the pledged property, without delivering the property to the creditor.

b. Substitution of Collateral

Mexican law does not have a general provision for a floating lien, or a lien in after acquired collateral. Although Section 335 of the LNICT is applicable to some financing scenarios, and does allow substitution of assets under a pledge contract without a new filing, the law is not completely clear. Therefore, in practice, lenders generally file a new pledge contract if the assets are substituted to be sure of obtaining a perfected security interest in the new assets. If the parties create a nonpossession guaranty, the debtor has the right to sell or transfer, during the course of his activities, the pledged property.<sup>38</sup>

c. Lien Searches

It is possible to do a lien search in the Public Registry of Property upon filing an appropriate application, but this is generally not as quick, convenient, or certain as doing a Uniform Commercial Code search in the United States. Unfortunately, the Public Registry of Property may not find all documents of record, and in large transactions lenders often use a private firm to search the records.

3. *Intervening Claims*

The following are some possible intervening claims that might take a priority position over the lender's position under the pledge contract.

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38. L.T.O.C., art. 356.

a. Liens for Wages, Salaries, and Severance Pay

If the *Maquiladora* employs Mexican workers, liens for wages, salaries, and even legally mandated severance pay, could attach to the collateral of the *Maquiladora*.<sup>39</sup> These types of liens have priority over other kinds of claims, including secured claims. It is important to remember, however, that the lender in a *Maquiladora* financing transaction should be protected against these types of liens, if the *Maquiladora* is clearly only the bailee or depository of the collateral, and not the owner. To emphasize this point, the pledge contract should clearly state that title to the collateral does not pass to the *Maquiladora*, and the pledge contract should be filed with the Public Registry of Property to put the world on notice of this fact. Notwithstanding the foregoing, the removal of liens for wages, salaries, and severance pay could take many months. Therefore, a lender may wish to monitor the number, or amount of labor claims, made against the *Maquiladora* by adding this item to the list of reports required to be made by the U.S. Parent, pursuant to the loan documentation.

b. Subsequent Liens

A borrower may grant more than one pledge covering collateral.<sup>40</sup> The general rule under Mexican law, is that the pledge that has been recorded first in the appropriate Public Registry of Property will be given priority, and only after the first priority lender has foreclosed upon its pledge, and has been paid in full will the subsequent pledgee be able to enforce its pledge.<sup>41</sup>

c. Nationalization Risks with Respect to Collateral

The Mexican government has the constitutional authority to expropriate property when there is a justified "public utility" cause for doing so.<sup>42</sup> This is a risk that should always be considered when making a loan to be secured by collateral to be located in Mexico.

d. Tax Obligations

Generally, pledges that have been duly recorded with the Public Registry of Property, prior to the notification of a tax obligation by the tax authorities, will have a preference over the latter with respect to the assets subject to the pledge.<sup>43</sup> However, if a tax lien is filed against the *Maquiladora*, it could take several months to have the lien removed, even if the pledge has priority over the tax lien and no obstacles were encountered during the procedure.

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39. C.C.D.F., art. 2989 grants workers the right to demand payment of salaries and benefits owed during the previous year. Claims must be filed before the Labor Authority having jurisdiction over the matter, and its resolution shall provide for the sale of any of the debtor's property, as necessary to obtain priority over other kinds of claims. *Id.*

40. L.T.O.C., arts. 350, 358.

41. C.C.D.F., art. 3013.

42. "Constitucion Politica De Los Estados Unidos Mexicanos" [Mexican Federal Constitution] art. 27, see <http://info4.juridicas.unam.mx/ijure/fed/9/> [last visited on Aug. 22, 2002].

43. C.C.D.F., art. 2857.

### C. THE COMMODATUM

In a loan transaction, in addition to the pledge contract, all three parties should execute a separate *Commodatum*, evidencing the bailment of the collateral from the U.S. Parent to the Mexican Subsidiary. The lender should also be a party to the *Commodatum* to receive the benefit of its terms, and to be sure that the *Commodatum* is not modified or terminated without the lender's knowledge or consent.

### D. ENFORCEMENT

#### 1. General Rules under Mexican Law

Pursuant to Articles 341 and 342 of the LNICT, if the borrower does not pay the loan when due, the lender may order the pledged property to be sold to pay the amounts due under the loan. However, self-help by a secured party is generally not allowed. Therefore, a proceeding similar to a judicial foreclosure should be used unless: (i) the borrower and the *Maquiladora* voluntarily surrender the collateral to the lender (which voluntary surrender should be memorialized in a writing for evidentiary purposes); or, (ii) the lender obtains a letter from the borrower and the *Maquiladora* signed AFTER the default, allowing the lender to repossess the collateral without using judicial process.<sup>44</sup>

There are specific rules governing the Mexican enforcement procedures. A specific description of these procedures is beyond the scope of this article, but suffice it to say that it is recommended that lenders use judicial assistance with the help of knowledgeable local Mexican counsel, who are very familiar with the local judicial system, in order to obtain control of the collateral in Mexico. Estimates on the time required to obtain repossession of collateral in Mexico range from six to twenty-four months. In any event, it is important to remember that the collateral was imported into Mexico pursuant to the *Maquiladora* program, which requires the collateral be re-exported from Mexico back to the United States. If, instead, the collateral is to be sold in Mexico, import duties may then have to be paid.

#### 2. Return of the Collateral to the United States

##### a. Cooperation of U.S. Parent

Notwithstanding the foregoing remedies available under Mexican law, it is important to remember that this transaction has also been documented as a United States transaction with the U.S. Parent. The U.S. Parent will be required in the security agreement to return the collateral to the United States upon a default. The collateral has been "bailed" to the *Maquiladora* by the U.S. Parent pursuant to the terms of the *Commodatum*, which permits the U.S. Parent to obtain the return of the bailed property at any time. The *Maquiladora* program allows export documentation from Mexico to be obtained relatively easily in this type of situation, where the U.S. Parent is cooperative in obtaining the return of the collateral.

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44. *Id.* arts. 2883, 2884.

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b. Failure of U.S. Parent to Cooperate

If the U.S. Parent refuses to cooperate in obtaining the return of the collateral, the lender would have to institute an action to obtain control over the collateral, and would have to arrange for the export of the collateral from Mexico to the United States. The specific procedures to be followed under United States and Mexican law to obtain control of the collateral, and return it to the United States are beyond the scope of this article, but suffice it to say that an action for receivership against the U.S. Parent could be initiated in the United States, with the appointed receiver demanding the return of the collateral from the *Maquiladora*, pursuant to the terms of the *Commodatum*. Generally, these procedures will take more time and be more costly than if the U.S. Parent cooperated with the lender. As noted above, estimates on the time required to obtain repossession of collateral in Mexico range from six to twenty-four months. The time it will take to have a receiver appointed through a United States action, should be added to the estimated repossession time in Mexico.

c. International Arbitration

A lender or lessor should consider whether to add a provision for binding international arbitration in its loan or lease documentation. One advantage of international arbitration, is that neither the United States nor Mexico is a party to the international convention for the enforcement of judgments, but are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Therefore, it is almost always more difficult, time consuming, and expensive to enforce a United States judgment in Mexico (if ever), than to enforce a United States arbitration award in Mexico. Another advantage of arbitration is that arbitrators who have some expertise in the subject matter can generally hear the case, and the selection of language and other procedural matters can be agreed upon in advance. Of course, it is important to remember that general rules of evidence are not necessarily controlling. Therefore it is important to set forth, in any arbitration provision, the rules to be followed with respect to discovery, evidence, etc. Further, if a provision for international arbitration is added to the loan or lease documentation, it is important to provide that the location of the arbitration will be in the United States, the arbitrators will be American from a defined pool of professional arbitrators, and the language of the arbitration and decision will be English.

E. BANKRUPTCY ISSUES

1. General Rule

If the *Maquiladora* files for bankruptcy under Mexican law, the general rule is that secured creditors are preferred over other unsecured creditors, up to the value of the goods pledged.<sup>45</sup> However, the legal expenses of administering and preserving the assets of the bankruptcy estate and unpaid wages, salaries, and legally mandated severance obligations of the bankrupt company for workers whose services were used in the year

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45. "Ley De Quiebras Y Suspension De Pagos" [Mexican Federal Law of Bankruptcies and Suspension of Payments] [hereinafter L.Q.S.P.], arts. 261, 264, 265.

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preceding the bankruptcy, will take priority over both secured and unsecured claims of the bankrupt debtor.<sup>46</sup> A complete description of the Mexican bankruptcy system, and its procedures is beyond the scope of this discussion. However, it is important to remember that the bankruptcy system in Mexico is substantially different than that of the United States, and the outcome of a particular case may not be as clear as under the United States Bankruptcy Code. Therefore, a Mexican attorney with expertise in the Mexican bankruptcy system is essential and invaluable.

## 2. Effect of *Commodatum*

Notwithstanding the foregoing, it is important to remember that the pledged collateral is the property of the U.S. Parent and is only being "bailed" through the *Commodatum* to the *Maquiladora*. It may be possible, therefore, for the U.S. Parent to successfully file a separate proceeding requesting that the collateral be separated from the assets, subject to the *Maquiladora's* bankruptcy, and returned to the U.S. Parent under a "separation from bankruptcy" theory. If the *Maquiladora* objects to the separation, the Mexican courts will determine ownership of the collateral.

## VI. U.S. and Mexican Income Tax Consequences of *Maquiladora* Loan Transactions

The U.S. and international tax consequences of any cross-border transaction, can largely dictate how, and in what form, the transaction will be structured. This is certainly the case with equipment financing and other *Maquiladora* financing transactions with a U.S. parent company. Of course, to the extent the parent corporation is from a jurisdiction, other than the U.S., such as Japan, Taiwan, or Germany, the tax consequences in those particular jurisdictions should be carefully analyzed.

### A. U.S. INCOME TAX CONSEQUENCES

First, assuming the "typical" *Maquiladora* structure is involved (see the diagram at the beginning of this article), the U.S. Parent will have a number of U.S. tax issues to consider. If the U.S. Parent leases the equipment directly from a U.S. leasing company (as is often the case, and often required by the U.S. leasing company), the ultimate use of the equipment in Mexico will have both U.S. and Mexican tax consequences.

#### 1. U.S. Alternative Depreciation System

For U.S. tax purposes, the general depreciation method used for leased assets is the modified accelerated cost recovery system (MACRS),<sup>47</sup> which is advantageous to the lessor. However, leased assets located outside of the United States for more than 50 percent of the time during a taxable year, are treated as property used outside of the United States.<sup>48</sup> As such, they will not be eligible for MACRS. Instead, such assets must

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46. C.C.D.F., art. 2989.

47. I.R.C. §168(g)(2) (2001).

48. *Id.* §168(g)(4).

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be depreciated using the Alternative Depreciation System. The Alternative Depreciation System requires depreciation of the asset using the straight-line method, employing the half-year or mid-quarter convention, as applicable, over a period generally equal to the asset's class life. This depreciation method is not accelerated, and is less advantageous to a lessor than MACRS generally. The lessor's finance and pricing personnel for these transactions, should consider these issues carefully. If the Mexican subsidiary corporation uses the equipment in Mexico, no U.S. source income will be generated, and therefore cause no U.S. income taxation of the Mexican subsidiary company.<sup>49</sup>

## 2. U.S. Transfer Pricing Considerations

If the U.S. Parent owns the equipment and allows its Mexican subsidiary corporation to use the equipment for less than a fair market value lease rate, the Internal Revenue Service ("IRS") is likely to attempt to impute U.S. income to the U.S. corporation under the transfer pricing rules.<sup>50</sup>

The transfer pricing rules focus upon whether the prices charged between two or more commonly-controlled or owned companies for a product, service, facility, or other property, are consistent with a so-called "arm's length price" standard. The IRS is primarily concerned with obviating the ability of a taxpayer to shift taxable profits into a related company, which is subject to a lower or zero tax rate, thereby attempting to avoid U.S. tax. The 1994 transfer pricing regulations address that concern and provide, in part, as follows:

...[a] controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction, under the same circumstances (arm's length result).

Section 482 provides the Commissioner with authority to re-allocate income, deductions, credits, and other items among controlled parties. A wholly owned subsidiary Mexican corporation is an example of a company that could potentially be subject to I.R.C. Section 482, due to the ownership of the U.S. Parent. In evaluating a transaction between related parties, the critical inquiry is whether the transaction in question would have been similarly effected by unrelated parties dealing at arm's length.<sup>51</sup> If not, the

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49. *Id.* §861(a)(4).

50. Internal Revenue Code ("I.R.C.") Section 482 provides in relevant part as follows:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly, or indirectly, by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes, or clearly to reflect the income of any of such organizations, trades, or businesses. See <http://www.intltaxlaw.com/shared/transfer/irc.htm#Section%20482> [last visited on Aug. 22, 2002].

51. *Ciba Geigy Corp. v. Commissioner*, 85 T.C. 172, 221 (1985).

regulations under Section 482 give the Internal Revenue Service authority to re-allocate income and deductions to achieve an arm's length result.

If the U.S. parent, therefore, fails to charge an arm's length equipment lease rate for the use of the financed equipment, income from the Mexican subsidiary could arguably be re-allocated to the U.S. Parent. The IRS (and the California Franchise Tax Board, to the extent the Parent Corporation is operating in, or incorporated in the State of California), would be interested in making a transfer pricing adjustment if the Mexican subsidiary is a foreign corporation for U.S. income tax purposes.

Special consideration should be made as to the form of the Mexican subsidiary entity. There may be tax advantages to establish a special purpose Mexican subsidiary company, that is structured as a foreign partnership, that would lease the equipment from the U.S. Parent and then sublease the equipment to its Mexican sister corporation. If the Mexican subsidiary is a foreign partnership,<sup>52</sup> the U.S. tax authorities would have little or no interest in making a transfer pricing adjustment since all of the income, expenses, deductions and credits will automatically flow up to the U.S. Parent. A detailed discussion of the tax benefits and costs of various structures is beyond the scope of this article.

#### B. MEXICAN INCOME TAX CONSEQUENCES

The Mexican tax consequences of the financing transaction can be even more important.<sup>53</sup> There are two general approaches that can be taken. First, the Mexican subsidiary company can operate under: (i) Mexico's safe harbor rules for *Maquiladora* operations; or, (ii) lease the equipment at a fair market value rate from the U.S. Parent. The Mexican tax consequences of both are quite different, and can be different for U.S. income tax purposes (see the discussion of Section 482 above). A background of Mexico's transfer pricing rules, and how the *Secretaría de Hacienda y Crédito Público* ("SHCP") applies to the *Maquiladora* industry are in order.

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52. A foreign entity can generally only be taxed as a foreign partnership (for U.S. income tax purposes), if it has made an election under Treas. Reg. §301.7701-3 (2001). A *Sociedad de Responsabilidad Limitada* is a Mexican entity eligible to elect to be taxed as a foreign partnership, but both the *Sociedad Anonima* nor the *Sociedad Anonima de Capital Variable* are "de facto" foreign corporations and are not eligible to be taxed as foreign partnerships. Treas. Reg. §301.7701-2 (2001) (hereinafter Treas. Reg.). A check the box election under Treas. Reg. §301.7701-3 (2001) will have no impact on the treatment of the company for Mexican tax purposes. See <http://www.unclefed.com/ForTaxProfs/irs-regs/11065900.pdf> [last visited on Aug. 24, 2002].
53. For a more detailed discussion and analysis of Mexico's transfer pricing regime, please see TRANSFER PRICING ENFORCEMENT AND MAQUILADORA TAXATION IN MÉXICO by Lic. Carlos F. Pérez-Gautrin. Mr. Pérez-Gautrin is an associate in the international practice group of the Tax Team at Procopio, Cory, Hargreaves & Savitch LLP. He received his Mexican Law degree (*Licenciado en Derecho*) in Hermosillo, Sonora, Mexico, at the *Universidad de Sonora* in December of 1992. He obtained three Specialization degrees in the areas of Tax Law, Administrative Law, and Corporate and Economic Law, in Mexico City, Mexico, at the *Universidad Panamericana*. Mr. Pérez-Gautrin received his LL.M. in International Taxation in New York, New York at the New York University School of Law in 2001. He is currently awaiting admission to the state bar of California.
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### 1. Mexican Transfer Pricing and Enforcement

The *Maquiladora* sector was selected by SHCP as the target for the transfer pricing enforcement. As a consequence of a "Transitory Article"<sup>54</sup> of the Mexican Income Tax Law (ITL) entered into during 1995,<sup>55</sup> the *Maquiladoras* were expressly obliged to charge arm's length prices for their products and services. The Transitory Article was revised in 1997 to provide that a permanent establishment is deemed to be created by a foreign entity that deals with a *Maquiladora*, if their transactions are not at arm's length.<sup>56</sup> In a practical sense, the tax policy makers of Mexico used the permanent establishment exposure as a "measure" purported to enforce the compliance of transfer pricing provisions.

Significant tax consequences result when a foreign entity has a permanent establishment, including the obligation to report, and pay, Mexican taxes with regard to any income effectively connected to the permanent establishment.<sup>57</sup> Additionally, under the Regulations to the Internal Revenue Code, the United States does not allow a foreign tax credit for the income taxes paid in Mexico by a foreign entity, rendering manufacturing services partly from within and partly from without the United States, if a permanent establishment is deemed to be constituted in Mexico.<sup>58</sup> Therefore, a double taxation problem would arise against the foreign entity.

In furtherance of this trend, in 1997, six transfer pricing methods similar to those recognized by the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, were included in the domestic tax law of Mexico, in substitution of the return-on-capital method that did not yield the anticipated Mexican tax revenue results.<sup>59</sup> These methods are the following: Comparable Uncontrolled Price, Resale Price, Cost Plus, Profit Split, Residual Profit Split, and Transactional Net Margin Method.

It is worth noting that the Mexican transfer pricing system differs from the United States provisions mainly in two aspects. First, they adopt the Transactional Net Margin Method as opposed to the entity-based approach. Second, Mexican law does not expressly require the use of the most reliable method in making adjustments, so long as the result of using any transfer pricing method is reasonable.

In 1998, despite these changes, a change in tax policy was announced by the SHCP, under which the Transitory Article would be repealed effective as of January 1, 1999, and foreign entities dealing with *Maquiladoras*, by default, would be considered to have their own permanent establishment in Mexico. This action clearly put an oppressive financial burden on the *Maquiladora* industry. U.S. owners of *Maquiladora* manufacturing facilities were obviously concerned about the practical consequences.

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54. It is common practice in the Mexican tax legislation every time a new law or statute is enacted, to have transitory provisions in-force for an authorized period of time to allow the new law to become effective, without disrupting transactions entered into prior to its enactment.

55. "Ley del Impuesto Sobre La Renta" [ITL Transitory Article] [hereinafter L.I.S.R.] art. 4, see [http://noticias.juridicas.com/base\\_datos/Fiscal/140-1998.html](http://noticias.juridicas.com/base_datos/Fiscal/140-1998.html) [last visited on Aug. 24, 2002].

56. *Id.* art. 4(VI).

57. *Id.* art. 2.

58. See Treas. Reg.

59. L.I.S.R. art. 65.

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Accordingly, after several months of negotiations between the governments of the United States and Mexico, a mutual agreement was signed by the United States Department of the Treasury and the SHCP, and released on October 29, 1999 (the "Mutual Agreement"). The SHCP announced the Mutual Agreement is not to "increase" taxes paid by the *Maquiladoras*, but to distribute them in a more "equitable" way between the signatory countries.<sup>60</sup>

According to the Mutual Agreement, the foreign entity (e.g., U.S. company) is not considered to have a permanent establishment, and therefore is not subject to the double taxation potential, as long as the *Maquiladora* satisfies any of the two alternative requirements established in the Mutual Agreement. These two requirements are as follows:

- The *Maquiladora* must report a taxable profit, computed by a factor applied by 6.9 percent of the total asset value; or, 6.5 percent of the total costs and operating expenses of the *Maquiladora*, whichever is higher (the "Safe Harbor"); or,
- The *Maquiladora* must secure an advanced pricing agreement (APA) from the SAT, confirming that it has complied with the transfer pricing provisions set forth in Mexico's domestic tax law.

Even though the Mutual Agreement was, in principle, applicable from 2000 to 2002, an addendum extended the Mutual Agreement life beyond 2002.<sup>61</sup>

a. Operating the Mexican Subsidiary through  
the Safe Harbor Regime

Mexican Income Tax Law (*Ley del Impuesto Sobre la Renta*, or the "ITL") generally defines when nonresident individuals and corporations of Mexico are subject to Mexican tax, from their income connected to Mexican sources of income. The ITL establishes several types of income for nonresidents of Mexico, that can be considered as connected to a Mexican source of wealth and hence taxable in Mexico.

Thus, income derived from the grant of use of goods (e.g., leasing) by a non-Mexican resident, is deemed as connected to a Mexican source of wealth, if such goods are used for commercial purposes within Mexico.<sup>62</sup> In cross-reference with Articles 16 of the Federal Fiscal Code, and 75 of the Commerce Code, the lease of equipment for manufacturing purposes is generally considered a "commercial" purpose. Where the user of the goods is a resident of Mexico (or has a permanent establishment), it is assumed that the goods are to be used in Mexico for the aforementioned purpose.

Therefore, the use of the lease-financed equipment in Mexico will cause Mexican taxation. The question is how much will the tax be (associated from the lease and use of that equipment). If the Mexican *Maquiladora* subsidiary has complied with Mexico's safe harbor rules, it must report a taxable profit, computed by a factor applied to 6.9 percent of assets value, or to 6.5 percent of total costs and operating expenses, whichever is higher. The equipment lease and its value could be part of this calculation.

60. See SHCP at <http://www.shcp.gob.mx/> [last visited on Aug. 24, 2002].

61. Press Release, Internal Revenue Service, MEXICAN AND U.S. AUTHORITIES EXTEND TAX REGIME APPLICABLE TO MAQUILADORAS BEYOND 2002 (Aug. 11, 2000) (IR-2000-56). See <http://www.irs.gov> [last visited on Aug. 24, 2002].

62. L.I.S.R. art. 149.

b. No Safe Harbor—Lease at Arm's Length Price

Alternatively, if the Mexican subsidiary has not opted into the Safe Harbor rules, an arm's length lease income rate (from the financing lease) would be imputed, and therefore be subject to a Mexican withholding tax at a rate of 21 percent. The withholding tax is assessed on a gross amount basis and consequently, no business deductions are available to the Mexican subsidiary regarding the deemed lease payment to the U.S. Parent. This Mexican withholding tax is important to understand, since it would typically be applicable, even if the *Maquiladora* operations are not profitable, and the safe harbor regime is not complied with. The exact structure of the equipment financed leases, are therefore, very important.

C. "GROSS UP" LANGUAGE

Of course, the international tax complexities of these cross-border financing transactions usually motivate the U.S. lender to incorporate tax "gross up" language. This normally protects the lender from the international tax costs and risks associated with the transaction, and take them out of the business of deciding what structure is most advantageous for international tax purposes. The gross up language simply proves that the lender will be entitled to their gross rent and/or loan payments, without deduction for any Mexican or U.S. taxes, that might otherwise apply to the transaction.

## VII. Conclusion

Since *Maquiladora* financing transactions are necessarily international in their structure, the planning of how the finance transaction is structured, is of particular importance for all parties for several reasons. The substance of the financing documents can also have a significant impact on the economic costs and risks assumed by the U.S. Lender, the U.S. Parent, and the Mexican *Maquiladora*. Finally, constant changes in Mexican laws (e.g., the *Maquiladora* transfer pricing rules and secured financing laws) mean that both the U.S. Lender, and U.S. Parent, should be particularly vigilant with their cross-border financed transactions.

